No. 92-267

IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

UJB FINANCIAL CORP., *et al.*,

Petitioners,

v.

IRWIN SHAPIRO, ROBERT BASSMAN, JEROME KATZ, NORMAN SALSITZ, JEAN LEE and CHAPPAQUA FAMILY TRUST,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

MOTION FOR LEAVE TO FILE BRIEF AND BRIEF OF THE AMICUS CURIAE AMERICAN BANKERS ASSOCIATION IN SUPPORT OF PETITIONERS

JOHN J. GILL III
General Counsel
Counsel of Record

MICHAEL F. CROTTY
Deputy General Counsel for Litigation

THOMAS J. GRECO
Associate General Counsel

AMERICAN BANKERS ASSOCIATION
1120 Connecticut Avenue, N.W.
Washington, D.C. 20036
(202) 663-5026

Attorneys for Amicus Curiae

September 11, 1992

PRESS OF BYRON S. ADAMS, WASHINGTON, D.C. (202) 347-8203

IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

No. 92-267

UJB FINANCIAL CORP., *et al.*,

Petitioners,

v.

IRWIN SHAPIRO, ROBERT BASSMAN, JEROME KATZ, NORMAN SALSITZ, JEAN LEE and CHAPPAQUA FAMILY TRUST,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

---

MOTION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE

The American Bankers Association, a trade association representing the interests of the commercial banking industry, respectfully moves for permission to file the attached brief as amicus curiae in support of the Petition for a Writ of Certiorari filed by UJB Financial Corp., et al.

The consent of all parties to this action for filing the attached amicus curiae brief has been requested. The attorneys for the Petitioners have agreed to the

filing of the attached amicus brief. The attorneys for the Respondents have withheld consent.

The complaint in *Shapiro v. UJB Financial Corp.*, 964 F.2d 272 (3d Cir. 1992) is all too typical of the cookie cutter pleadings filed against banks in the wake of the downturn in the market for commercial real estate. Among the oft seen claims is the charge that a bank (or bank holding company) and its officers and directors have committed securities fraud by failing to "provide for adequate loan loss reserves." *Id.* at 276 n.6.

Because such suits—even when entirely meritless—are tremendously expensive for both the parties and the legal system as a whole, it is imperative that this Court provide guidance and emphasize that the lower courts must enforce Rule 9(b)'s requirements for adequately pleading facts to support securities fraud claims in the context of reserving against loan losses. This amicus believes that the Third Circuit adopted the wrong standard which will encourage the continued filing of such debilitating suits.

Amicus seeks to file the attached brief to emphasize the importance of this case to the banking industry and, in particular, to explain the accounting concept of reserving against loan losses which forms one of the central issues in the Respondents' complaint.

Respectfully submitted,

JOHN J. GILL III
Counsel of Record
AMERICAN BANKERS ASSOCIATION
1120 Connecticut Avenue, N.W.
Washington, D.C. 20036
(202) 663-5026

September 11, 1992

QUESTION PRESENTED FOR REVIEW

Did the Third Circuit err in announcing a new, "relaxed" application of Rule 9(b), Fed. R. Civ. P., which flatly conflicts with the standards of the First, Second and Seventh Circuits, as well as the standard previously established by the Third Circuit (including as applied by a different panel of the Third Circuit on the same day)?

TABLE OF CONTENTS

	Page
QUESTION PRESENTED FOR REVIEW	i
TABLE OF AUTHORITIES	iii
INTEREST OF THE AMICUS CURIAE	1
REASONS FOR GRANTING THE WRIT	3
CONCLUSION	8

TABLE OF AUTHORITIES

Page

CASES:

Billard v. Rockwell International Corp., 683 F.2d 51 (2d Cir. 1985) 7

Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, *reh'g denied*, 427 U.S. 884 (1975) 8

Christidis v. First Pennsylvania Mortgage Trust, 717 F.2d 96 (3d Cir. 1983) 8

DiLeo v. Ernst & Young, 901 F.2d 624 (7th Cir. 1990) 7

Romani v. Shearson Lehman Hutton, 929 F.2d 875 (1st Cir. 1991) 7

Shapiro v. UJB Financial Corp., 964 F.2d 272 (3d Cir. 1992) 3

Wool v. Tandem Computers, Inc., 818 F.2d 1433 (9th Cir. 1987) 7

STATUTES:

Fed. R. Civ. P. 9(b) ..... *passim*

MISCELLANEOUS:

Accounting Standards - Current Text - General Standards as of 1989 5

American Institute of Certified Public Accountants - Banking Committee - *Audits of Banks*, (2d ed. 1983) 5

Brookes, *Regulators Creating a Credit Crisis?*, Washington Times, May 3, 1990 2

Financial Accounting Standards Board, *Statement of Financial Accounting Concepts No. 6 - Elements of Financial Statements* (1985) 4

Golembe Associates, *The Adequacy of Bad Debt Reserves for Banks - A Preliminary Study* (1972) 4

T. Hardy, *The Allowance for Loan Losses: Fact or Fiction?* (June, 1986) 4,5

Table of Authorities Continued

	Page
Office of the Comptroller of the Currency, *Comptroller's Handbook for National Bank Examiners* (1984)	6
Pitt and Groskautmanis, *Shareholder Suits Suggest Some Lessons*, Nat'l L. J., August 10, 1992	2
Robert Morris Associates, *Managing the Allowance for Loan and Lease Losses State of the Art* (1988)	6
Sands, *Lending Practices Land Banks in Court*, Washington Times, April 20, 1990	2

IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

No. 92-267

UJB FINANCIAL CORP., et al.,

Petitioners,

v.

IRWIN SHAPIRO, ROBERT BASSMAN, JEROME KATZ, NORMAN SALSITZ, JEAN LEE and CHAPPAQUA FAMILY TRUST,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

---

MOTION FOR LEAVE TO FILE BRIEF AND BRIEF OF THE AMICUS CURIAE AMERICAN BANKERS ASSOCIATION IN SUPPORT OF PETITIONERS

INTEREST OF THE AMICUS CURIAE

The American Bankers Association ("ABA") is the principal national trade association of the commercial banking industry in the United States. It has members in each of the fifty states and the District of Columbia and represents bank of all types (national and state chartered banks) and sizes (money center,

regional and community banks). ABA members hold approximately ninety percent of all domestic assets in commercial banks located in the United States.

The matter decided by the Court of Appeals involves a legal issue of the utmost concern to the banking industry. As this Court is no doubt aware, certain segments of the United States economy have suffered through a lingering recession, particularly with respect to real estate. Compounding this economic downturn has been the widely reported perception that the banking regulators, particularly the Office of the Comptroller of the Currency, have become extremely strict during their examinations and have been requiring banks to increase their loan loss reserves. *See, e.g.*, Brookes, *Regulators Creating a Credit Crisis?*, Washington Times, May 3, 1990. When loan loss reserves are increased, it is as if the bank spent or lost that money at the time the reserves are set aside. That has an effect upon the net income of the bank and, ultimately, upon the market value of bank stock. It is easy, with benefit of hindsight, to claim that "adequate" loan loss reserves should have been set aside earlier so as to present a more "accurate" picture of the true value of a bank's stock. In fact, numerous shareholder suits have been filed against banks containing allegations of securities fraud because of losses in the banks' loan portfolio. *See*, Sands, *Lending Practices Land Banks in Court*, Washington Times, April 20, 1990, at C1. *See also*, Pitt and Groskautmanis, *Shareholder Suits Suggest Some Lessons*, Nat'l L. J., August 10, 1992, n.7 at 27 (discussing proliferation of class actions alleging securities law violations and noting Wall Street Jour-

nal article stating over 300 such suits had been filed in 1990-91.)

Because of the expense of such lawsuits and because it is impossible to run a bank if honest and reasonable business judgments are made into guarantees of positive investment results—or guarantees of costly litigation from shareholders charging those judgments were faulty—it is extremely important that courts be able to dismiss such suits which fail to plead facts demonstrating the fraudulent activity being charged, as opposed to simply showing that management failed to predict the future. The American Bankers Association files this brief to explain the concept of reserving against loan losses in order to help the Court assess the correctness of the Court of Appeals' decision.

REASONS FOR GRANTING THE WRIT

One of the key holdings below was that the Respondents could plead defendants' allegedly fraudulent failure to provide for adequate loan loss reserves without any supporting facts showing how such reserves were improperly set, and based solely on hindsight. This presents an important question of federal law which has not yet been addressed by the Court but should be: What is the standard for adequately pleading securities fraud under Fed. R. Civ. P. 9(b)?

The Third Circuit would permit plaintiffs in such suits to state that the facts which form the basis of the allegedly fraudulent activity lie exclusively within the defendants' control and thereby satisfy Rule 9(b)'s requirement that the circumstances constituting fraud be "stated with particularity." *Shapiro v. UJB Financial Corp.*, 964 F.2d 272, 285 (3d Cir. 1992). Rather

than repeating the arguments made by the Petitioners and other amici, this amicus believes that it would help the Court to review the meaning and purpose of the particular accounting concept involved in this case.

The allowance for loan losses appears on a balance sheet as a deduction from the value of a loan portfolio. Commentators have recognized several functions which could be served by the reserve. These include an experience function, catastrophe function, and a valuation function. Golembe Associates, *The Adequacy of Bad Debt Reserves for Banks—A Preliminary Study* at 2 (1972). *See, also,* Financial Accounting Standards Board, *Statement of Financial Accounting Concepts No. 6—Elements of Financial Statements* at 9134 (1985) (hereinafter FASB No. 6). The experience function assumes that the loan loss reserve is intended to absorb losses which can be expected to occur in a single average year and is achieved by averaging out actual loss experience from past years. It is viewed as producing "the lowest benchmark" for the loss reserve. T. Hardy, *The Allowance for Loan Losses: Fact or Fiction?* at 8 (June, 1986) (unpublished theses available at the American Bankers Association library).

In contrast to the experience function, a loan loss reserve based on the catastrophe function assumes that the allowance should enable the lender to withstand loan losses which would occur under unforeseen economic crises such as a depression. *Id.* This probably represents the upper limit on the amount of the reserve but would "artificially inflate the allowance amount and make it difficult for the public as well as bank management to evaluate the problems inherent in a loan portfolio." *Id.* at 9.

Somewhere between these two extremes is the notion of the loan loss reserve serving a valuation function. For example, FASB No. 6 states that some accounts on a balance sheet serve as valuation accounts (i.e., a separate item which reduces or increases the carrying amount of an asset). In this context the loan loss reserve would "represent a measure of all losses expected in a given loan portfolio through its liquidation in the ordinary course of business." T. Hardy, *supra*, at 10.

The guidance from the accounting profession makes it clear that the loan loss reserve is to serve a valuation function for financial reporting purposes. "The amount of [the loss reserve] can be considered reasonable when the allowance for loan losses . . . is considered by management to be adequate to cover estimated losses inherent in the loan portfolio." American Institute of Certified Public Accountants—Banking Committee, *Audits of Banks* at 61 (2d. ed. 1983).

As to when and in what amounts such losses need to be identified, the accounting standards recognize the difficulty of this undertaking. FASB Statement No. 5, for example, requires that the loss be probable and reasonably estimable before it is accrued. Financial Accounting Standards Board, *Accounting Standards—Current Text—General Standards* at § C59.105. (Losses from uncollectible receivables, *e.g.*, principal and interest on loans, shall be accrued when both conditions, probable and reasonably estimable, are met.) The banking regulatory guidance is similar. "It is not the examiner's responsibility to initially ascertain the amount of allowance, but rather to determine that management has exercised its responsibility to

use *reasonable* judgment based upon reliable information to arrive at an appropriate allowance." Office of the Comptroller of the Currency, *Comptroller's Handbook for National Bank Examiners* § 217.1 at 2 (1984) (emphasis added).

What is readily evident from the discussion above is the subjective process for arriving at the "correct" amount of loan loss reserves. Unlike such objective entries on a financial statement as inventory and sales, the amount stated for loss reserves is nothing more than an educated prediction of future events. Robert Morris Associates, *Managing the Allowance for Loan and Lease Losses State of the Art* at 11 (1988). This prediction will likely be based on a system which sets forth a particular method of evaluation (*e.g.*, frequency of review, documentation, minimum allowable allowance, identification of problem loans, allocation of loss for specific loans, etc.) but the decision ultimately remains a guess. *Id.* at 55-60.

As events play themselves out, and with 20-20 hindsight, the correctness of the loan loss reserve calculation can easily be evaluated. In today's economy, for example, it has become evident that some financial institutions failed to anticipate the extent of the difficulty which would be encountered by certain regions and within certain industries. But miscalculations of the loss reserve, even by a significant amount, do not, standing alone, represent fraudulent acts by the lending institution.

Shareholder suits, such as the one at issue in this case, typically make broad allegations of fraud based on the inadequacy of loss reserves and are primarily, if not exclusively, based on 20-20 hindsight. The argument made in such suits is that the bank's financial

disclosures state loan loss reserves which later prove to be "inadequate" and, therefore, constitute fraud under section 10(b) of the Securities Act of 1934. Plaintiffs typically demand broad discovery orders seeking the banks' loan files in an effort (again with the benefit of hindsight) to determine what the reserves "should have been."

Because of the expense of this type of litigation, it is extremely important for courts to hold plaintiffs to the requirement of Rule 9(b) that fraud claims be supported by allegations of fact pled with "particularity." *Billard v. Rockwell International Corp.*, 683 F.2d 51 (2d Cir. 1985) (Rule 9(b) will be strictly construed to minimize strike suits). In this case, for example, it is not an overwhelming burden to require the plaintiffs to identify specifically in what respect the loan loss reserves were false or misleading at the time the estimates were made. "[M]ere conclusory allegations of fraud are insufficient, statements of the time, place *and nature* of the alleged fraudulent activities are sufficient." *Wool v. Tandem Computers Inc.*, 818 F.2d 1433, 1439 (9th Cir. 1987) (emphasis added). *See*, *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir.1990) (plaintiffs' complaint that bank's failure to increase reserves constituted fraud inadequate under Fed. R. Civ. P. 9(b) because circumstances of the fraud "the who, what, when, where and how" not specified). As the court noted in *Romani v. Shearson Lehman Hutton*, 929 F.2d 875 (1st Cir. 1991), "We have been especially rigorous in demanding such factual support in the securities context to minimize the chance 'that a plaintiff with a largely groundless claim will bring a suit and conduct extensive discovery in the hopes of obtaining an increased

settlement. . . .'" *Id.* at 878 (citations omitted). *See also, Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 741, *reh'g denied*, 423 U.S. 884 (1975) (threat of discovery may add "*in terrorem*" increment to settlement value).

Ironically, the Third Circuit itself has recognized the importance of meeting the pleading requirements of Rule 9(b) where allegedly inadequate loan loss reserves form the basis of the plaintiffs' securities fraud suit. The court, in *Christidis v. First Pennsylvania Mortgage Trust*, 717 F.2d 96, 100 (3d Cir. 1983), affirmed the dismissal of such a complaint because of "the complete absence of any disclosure of the manner in which, in establishing reserves for bad debts . . . the defendants knowingly departed from reasonable accounting practices." In this case, however, the Third Circuit merely plays lip service to *Christidis* before announcing its lesser pleading standard. In doing so the Third Circuit's crafting of a reduced pleading standard departs from the express requirements of Rule 9(b) and the application of the rule by other courts, sends the wrong signal to the plaintiff bar, and ignores the policies behind the heightened pleading requirement of Rule 9(b).

CONCLUSION

The amicus urges this Court to grant the petition for a writ of certiorari. The ruling below relaxes the standards for pleading in fraud cases and allows plaintiffs to pursue often groundless allegations and engage in discovery "fishing expeditions." If this Court allows the Third Circuit's rewriting of Rule 9(b) to stand, banks and other commercial enterprises are certain to continue to face unfounded charges of fraud

every time economic reversals cause investors to lose money.

Respectfully submitted,

JOHN J. GILL

MICHAEL F. CROTTY

THOMAS J. GRECO
Attorneys for Amicus Curiae
AMERICAN BANKERS ASSOCIATION
1120 Connecticut Avenue, N.W.
Washington, D.C. 20036
(202) 663-5026

September 11, 1992